

As discussed in more detail below, the “Cash Value” of each Contract reflects: (1) Net Premiums paid under the Contract, (2) cost of insurance charges, (3) any increases or decreases as a result of market performance in the variable subaccounts, (4) the amount of any partial surrenders, (5) policy indebtedness, and (6) all other fees, deductions, and charges assessed under the Contract.

Each Contract provides for a minimum death benefit that is calculated by multiplying the Contract’s “Cash Value” by a percentage identified in the Contract. The applicable percentage is intended to equal the amount required to maintain the Contract’s compliance at all times with the CVA test.

Each Contract provides for the payment of “planned premiums,” which are the premiums that the Contract owner expects to pay in specified installments over the life of the Contract. Premiums paid by a Contract owner, net of the certain charges, are allocated (and may be later reallocated) by the owner to one or more variable “Subaccounts” available under the Contract. Amounts allocated or reallocated to a particular “Subaccount” are applied to purchase “Accumulation Units” in that “Subaccount,” and the value of such units fluctuates with the investment experience of the assets in which the “Subaccount” is invested. Charges that are assessed under a Contract are deducted on a pro rata basis from the values held in the “Subaccounts.”

Each Contract provides that the Taxpayer can borrow up to 90 percent of the Contract’s “Net Cash Value.” If the Contract owner exercises its right under the Contract to borrow against the Contract’s “Cash Value,” a portion of the “Cash Value” equal to the loan plus any accrued, unpaid interest thereon (policy indebtedness) is transferred to and held in the “Loan Account,” which is part of the Taxpayer’s general asset account. Interest is charged on policy indebtedness at a rate no greater than a guaranteed rate specified in the Contract.

After the first Contract year, a Contract owner may request a partial withdrawal from the Contract. The Contract must have a net “Cash Value” of at least \$X following a partial withdrawal. Partial withdrawals will reduce the Contract’s “Cash Value” and may reduce the face amount of insurance under the Contract.

In limited circumstances, upon the full surrender of a Contract, the Taxpayer will pay the Contract owner certain amounts (Remittances), which represent a portion of premium loads assessed in the year of surrender, in addition to the Contract’s “Net Cash Value.” Under the Contracts, the “Net Cash Value” on the surrender date equals the “Cash Value” on that date less any outstanding policy indebtedness.

The Remittance is payable only for surrenders occurring during the first three Contract years and applies only to premiums paid in the Contract year of surrender, not to all premiums paid since issue. The specific amount of the Remittance differs

depending upon the particular Contract, but in general it equals a percentage of the premiums received in the year of surrender. In all cases, the Remittance is less than the premium loads that were deducted from the premiums.

Incorporating the various benefits and charges applicable to the Contracts, each Contract defines “Cash Value” as follows:

After the Free Look Period, the Cash Value is the value of the [Contract’s] Accumulation Units in each Subaccount plus the amount in the Loan Account, less any mortality and expense risk charges which have accrued since the last Monthly Deduction Date.

Under the terms of the Contracts, the amount of a potential Remittance is not included in the Contract’s “Cash Value,” and the Taxpayer did not treat the Remittances as part of the “Cash Value” in administering the Contracts. Taxpayer interpreted the legislative history of section 7702 as indicating that the cash surrender value of a contract is any amount that the contract owner can both (i) receive upon surrender, and (ii) borrow under the contract; that is, that both characteristics must be present for an amount to be considered part of the value. Based upon this interpretation of section 7702, Taxpayer concluded that because the “Net Cash Value” of a Contract does not include the Remittance, the Remittance is not subject to borrowing under the Contract. Accordingly, Taxpayer concluded that the Remittance may be excluded from a Contract’s cash surrender value because it did not affect the amount available for a loan under the Contracts.

As a result of Taxpayer’s exclusion of the Remittance from a Contract’s “Cash Value,” the Remittance is not credited with interest or earnings as are other amounts that comprise the “Cash Value,” and the “Cash Value” is not increased in any manner as a result of the Remittance. In addition, the amount of a potential Remittance does not decrease the net amount of insurance risk with respect to a Contract, and hence, it does not decrease the cost of insurance charges that are assessed under the Contracts based upon that amount. Exclusion of the Remittance from a Contract’s “Cash Value” means that the minimum death benefit under the Contract during the first three Contract years (*i.e.*, the period in which the Remittance is payable) is less than what it would be if the Remittance were included in the “Cash Value.”

Consequently, Taxpayer’s failure to include the amount of a potential Remittance in the Contracts’ “Cash Value” caused an error under the CVA test in that the Contracts did not ensure that their cash surrender value within the meaning of section 7702(f)(2) did not at any time exceed the net single premium that would have to be paid at such time to fund future benefits under the Contract.

Taxpayer has corrected the error caused by the Remittance by adding an endorsement ("Endorsement") to the Contracts that includes the Remittance in the Contracts' "Cash Value" during the period that the Remittance could become payable. The Endorsement is effective as if added to the Contracts at issuance. As a result of the Endorsements, the Remittance is taken into account in calculating the minimum death benefit for the Contracts.

In addition, Taxpayer will recalculate the death benefit that was paid under the Contract, for each Contract under which the insured died at a time when a Remittance was payable but before the Endorsement was added to the Contract, by taking the Remittance into account as part of the value that is used to determine the minimum death benefit. If a lower death benefit was paid with respect to such a Contract, the Taxpayer will pay the Contract owner or beneficiary the difference between the actual death benefit paid and the death benefit calculated as just described, with interest.

Taxpayer represents that it has not issued any life insurance contracts using the forms upon which the Contracts were issued since the date the Endorsement was added to all in-force Contracts, and that if additional Contracts are issued, they will include the Endorsement at issuance.

LAW AND ANALYSIS

In general, section 7702 applies to all life insurance contracts issued after December 31, 1984. Under section 7702(a), to be considered a life insurance contract for federal tax purposes, a contract that is a life insurance contract under the applicable law must satisfy either the CVA test or the guideline premium limitation and cash value corridor requirements of section 7702(a)(2), (c), and (d).

Section 7702(b) provides that a contract satisfies the CVA test if, by the terms of the contract, the cash surrender value of the contract may not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract. For this purpose, section 7702(f)(2) provides that the cash surrender value of any contract shall be its cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends.

Under section 7702(f)(8), the Secretary of the Treasury may waive the failure to satisfy the requirements of section 7702 if the taxpayer establishes that the requirements were not satisfied due to reasonable error(s) and that reasonable steps are being taken to remedy the error(s).

The common definition of "cash surrender value" is "the amount made available, contractually, to a withdrawing policy owner who is terminating his or her protection."

Kenneth Black, Jr. and Harold D. Skipper, Jr., *Life & Health Insurance* 599 (13th ed. 2000); see also John H. Magee, *Life Insurance* 46 (3rd ed. 1958) (“The cash value represents the amount available to the policyholder upon the surrender of the life insurance contract.”).

In relevant part, the legislative history of section 7702 defines cash surrender value as the “cash value of any contract (i.e., any amount to which the policyholder is entitled upon surrender and against which the policyholder can borrow) determined without regard to any surrender charge, policy loan, or a reasonable termination dividend.” S. Pt. No. 98-169, at 573 (1984); H.R. Rep. No. 98-432, at 1444 (1984).

Section 1.7702-2(b)(1) of the proposed Income Tax Regulations defines “cash value” of a life insurance contract as the greater of (i) the maximum amount payable under the contract (determined without regard to any surrender charge or policy loan), or (ii) the maximum amount that the policyholder can borrow under the contract. 57 Fed. Reg. 59,319 (Dec. 15, 1992).

Section 1.7702-2(h)(2) of the proposed regulations provides that the cash surrender value of a contract generally equals its cash value, as defined in section 1.7702-2(b)(1) of the proposed regulations.

In Notice 93-37, 1993-2 C.B. 331, the Service announced that the effective dates of the proposed regulations under section 7702 would be no earlier than the date of publication of final regulations in the Federal Register. The Notice also indicated that insurance companies generally would be allowed a period of time after final regulations are published to bring their contracts into compliance with any new rules.

CONCLUSION

The Remittance that could be payable under a Contract should have been included as part of the Contract’s cash surrender value within the meaning of section 7702(f)(2)(A). Because the section 7702 proposed regulation’s definition of cash surrender value is not identical to the definition in section 7702’s legislative history, and because the proposed regulations have not been finalized, we conclude that the Contracts’ failure to satisfy the requirements of the CVA test is waived pursuant to section 7702(f)(8) because it was due to reasonable error and Taxpayer’s method of remedying the errors was reasonable.

We further conclude that Taxpayer’s correction of the errors will not affect the Contracts’ issue dates or the dates upon which they are considered to have been “entered into,” and does not result in a change in benefits under section 7702(f)(7) or a material change under section 7702A. Thus, the addition of the corrective Endorsement to the contracts will not cause the contracts to lose their “grandfathered” status for purposes of sections 72, 101(j), 264, 7702, or 7702A; will not require retesting or the

beginning of a new test period under sections 264(d), 7702(f)(7)(B)-(E), and 7702A(c); and will not be treated as an exchange for federal income tax purposes.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

/S/

Sheryl B. Flum
Branch Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)